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TO: The Board of Directors and Management of Missouri state-chartered credit unions

SUBJECT: Asset Diversification

Diversification of assets is a basic principle of sound financial management. This principle is based on protection of the credit union's assets by dividing funds among various categories of investments or loans. This is done to help mitigate and manage several types of risk that are associated with any asset. The purpose of this bulletin is to advise management of the need to establish a limit for specific categories of assets. Management needs to review the structure of the credit union's investment and loan portfolios to determine the appropriate mix of assets by maturity, credit quality, and interest rate risk, ensuring appropriate diversification.

Of special note are high risk lending programs. These programs include indirect lending, sub-prime lending, and new programs for which the credit union has no history.

Indirect lending relies heavily on third parties (auto dealerships) to facilitate borrowing. While third party arrangements may be cost effective, can enable credit unions to access expertise not available in-house, and promote programs that may otherwise be unfeasible, these relationships can also result in financial stress due to unanticipated costs, legal disputes, and asset losses.

Sub-prime lending has historically resulted in a higher percentage of failure for entities engaging in this business than for traditional lenders. This appears to be a result of many variables. Borrowers in this group may have a greater number of circumstances that could adversely affect their ability and/or willingness to repay the loan. Losses cannot be reliably predicted and can vary over a wider range than a portfolio of higher credit quality. These reasons alone dictate this type of lending must be limited in credit union portfolios.

In addition, 'loan to collateral value' for sub-prime lending equal or exceed ratios for other consumer lending. Based on the willingness and ability of a borrower with credit blemishes or lack of credit history to repay the loan, the lack of investment in the collateral by the borrower places the credit union at additional risk.

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New loan products for which the credit union has no history can also place undue financial burden on the credit union. Essential to the success of these program is due diligence in establishing the program and proper internal controls which monitor performance. Until a history of losses is established, management cannot fully assess the financial impact of the program.

Sound management practices dictate the limiting of high-risk portfolios. Consequently, the Division of Credit Unions has established a limit of **ten percent of assets** for each high-risk program. Any deviation from this limit must be supported by a detailed plan approved by the board of directors and reviewed by the examiner assigned to the credit union. The plan must be consistent with the credit union's overall asset liability management program. Overall, management must determine the potential for higher-than-anticipated losses does not seriously jeopardize the credit union.

Another area of recent concern is the amount of longer-term fixed rate loans (primarily first mortgages). The amount invested in these assets must also be limited to fit the credit unions ALM polices and risk tolerance levels. Any amount over twenty-five percent of assets makes risk mitigation efforts more essential and historically difficult to justify. To adequately protect members' funds, management must adhere to the principle of asset diversification.

John P. Smith

John P. Smith, Director **October 3, 2003**